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C O N F I D E N T I A L SECTION 01 OF 04 SANTO DOMINGO 006075

SIPDIS

DEPARTMENT FOR WHA/CAR, WHA/ECPS AND EB/IFD/OMA;
TREASURY FOR OASIA; NSC FOR SHANNON

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SUBJECT: AMBASSADOR AND EXIM BANK METTINGS WITH PRESIDENT, ECONOMIC CABINET AND IMF

REF: SANTO DOMINGO 5564

Classified By: Ambassador Hans H. Hertell; Reasons: 1.5 (B AND D)

¶1. (C) Summary: The Ambassador and Ex-Im Bank officials had a series of meetings October 20-21, with President Mejia, members of his economic cabinet and International Monetary Fund Representatives. Mejia expressed frustration about delays in disbursement of loans from the IMF and the multilateral development banks. GODR officials reaffirmed their commitment to the Fund program; separately, IMF representatives said they were working closely with the GODR and noted problems in the energy sector and political pressures on the President. Embassy is submitting septel its assessment of the Dominican financial and political situation. End summary.

¶2. (SBU) On October 20-21 an EXIMBANK team accompanied the Ambassador for discussions of the Dominican financial situation and bilateral lending. The group called first on Technical Secretary Carlos Despradel, Central Bank Governor Jose Enrique Lois Malkun and Finance Secretary Rafael Calderon; on October 21 they met President Mejia and visiting IMF staffers. EXIM officials also had contacts with local bankers and the private sector. (Exim team consisted of Senior VP for Finance Jeffrey Miller, Senior VP for Credit and Risk Assessment John McAdams, Counsel Peter Gilbert, and Country Manager Kathy Flanigan.)

Difficult times

¶3. (C) Technical Secretary Despradel reviewed the financial situation since the Baninter crisis emerged this past spring: the country has reduced imports 20-25 percent; even so, exports, tourism and remittances are at record levels. The GODR has reduced capital expenditures by 35 percent in nominal terms (60 percent if inflation is into acount). Inflation, running currently 35 percent, is a serious issue. One proximate cause has been the "tremendous outflow of capital." Despradel acknowleged that the government had increased its payroll 6 percent.

¶4. (C) Despradel reiterated his reluctance to approve any new debt, including any Ex-Im financing, except for projects of the very highest priority to the President (for example, water projects and asphalt). He said there was a lot of pressure on the President to approve costly projects, but he (Despradel) was opposed. If he approved anything at all, he wouldn't be able to control political pressure on other projects and the GODR would not meet IMF limits.

¶5. (C) Finance Secretary Calderon commented that "reports that arrive concerning the country are not always accurate." Calderon noted that the Dominican Republic had suffered external shocks over the past 2-3 years, "like the rest of the world." These included the U.S. economic slowdown, the effects on tourism of the Sept. 11 terrorist attacks and the Iraq war, oil price spikes, and Venezuela's cutoff of oil exports ("a situation that will remain bad as long as Chavez is in power"). On top of that, Calderon said, came the internal shock of Baninter, followed by two other bank failures, that have created a huge quasi-fiscal deficit. Calderon said that the GODR knew it had no choice but to assure monetary and fiscal discipline "with or without an IMF agreement."

¶6. (SBU) Calderon said that despite all of these adverse factors, GDP growth for 2002 was 4.2 percent. Although IMF has projected a three percent contaction in 2003, the first six months of the year showed only minus eight-tenths percent. He commented that exports for 2003 were at record levels; tourism was up 24 percent over last year, with hotel rooms "fully booked" until mid 2004; and remittances were up five percent over last year. Economic statistics showed strong investment, even in the electricity sector. (COMMENT: In contrast to this assurance, recent press reports show investment decreased more than 9 percent over last year, with

its annual contribution to GDP down nearly half over the past five years -- from 7.91 percent contribution to GDP in 1999, to a projected 3.98 percent for 2003.)

Status of arrears to USG

¶7. (C) Calderon expressed surprise when Ex-Im bank asked about GODR arrears of USD 600,000 to EXIM for a power project loan and said he had already instructed the Central Bank to pay.

¶8. (C) Central Bank Governor Lois Malkun told Ex-IM that the GODR was modestly in arrears to a number of creditors, and he could not say when Ex-Im might be paid. The Governor did takee note that if the arrears persisted byond November 15, Ex-Im would be taking steps to suspend lending.

Central Bank Outlook

¶9. (C) Central Bank Governor Lois Malkun offered a less optimistic assessment. He sees the GODR facing two principal problems: 1) a revenue shortfall, and 2) the consequences of the GODR decision not to honor the IMF's request to consult before buying out the shares of electricity distribution companies held by Spanish company Union Fenosa. Lois Malkun mentioned the President's frustration at the political obstacles to getting Congress to approve additional tax measures. Though the GODR had decreased expenditures, it had nevertheless acumulated USD 114 million in arrears in September -- a period for which the Fund agreement set a ceiling of USD 70 million in arrears. Lois Malkun said that the GODR had reduced arrears to USD 63 million by October 14, but could not continue to pay "without pesos." The Governor said a priority for him was obtaining disbursement of IDB and World Bank loans. He said that the GODR might need bridging finance. He projected an improvement in the exchange rate and economic conditions by December.

¶10. (C) Lois Malkun said that further serious problems had emerged in the banking sector after conclusion of the IMF agreement. Books at the failed Bancredito were not clear and might cause problems for the expected takeover of Banco Profesional by the Leon Jimenez Group. Even so, he expected the deal to be concluded very soon. He said the Central Bank did not intend to issue certificates of deposit to back Bancredito depositors, as it had with Baninter. (NOTE: we have heard from various sources that some CDs were issued quietly but then stopped. End Note.) The Governor said that other Dominican banks were in good shape and 40 auditors would arrive within the week to conduct the banking sector audit required by the Fund agreement.

President's View: A Long Time Coming

¶11. (C) President Mejia reiterated to the Ambassador and Ex-Im visitors his frustration at the slow disbursement of international financial institution (IFI) loans (reftel). He pointed to incomplete projects in the country and said that in three-and-a-half years of discussions and negotiations, he had received nothing from the World Bank, despite its repeated promises to assist with the electricity sector. The President blamed current economic problems on the banking sector crisis and said that subsequently, the IMF and IDB had paralyzed the country by not disbursing funds. The President said that if he did not help the people in need it, he would be thrown out and that he could not wait for "manna from heaven."

¶12. (C) Mejia again defended his decision to repurchase from Union Fenosa two of the country's three electricity distribution companies. Union Fenosa management had been exploitive and corrupt; the company had left many unpaid debts behind. GODR officials had commented earlier that the repurchase would improve cash flow and reduced GODR debt (arguing that as a partner, the GODR was already responsible for half of the companies' liabilities).

Raising Revenue

¶13. (C) CB Governor Lois Malkun, also present along with the other officials, said the GODR was still working with Congress on passing a five percent export tax, but indicated there was not much support among members. The Supreme Court recently declared unconstitutional the August presidential decree imposing the tax. Lois Malkun described the situation as "complicated" and said the GODR was working on other ideas. He commented that real fiscal reforms would be impossible prior to presidential elections. Technical Despradel was also pessimistic on that point: Congress would

not approve any tax increase and the business community would not support any tax that could not be directly passed on to the consumer. Despradel expressed concern that some elements of the GODR might propose some type of exchange rate control.

¶14. (SBU) Calderon noted that the GODR did have sources of funds to pay foreign debt and that those funds could not be used for other purposes. These included the 3 percent carbon tax (on fuel puchases), a two percent temporary import tax, the 0.15 percent check cashing fee, and the departure tax at airports, recently raised from USD 10 to USD 20.

The IMF view

¶15. (C) IMF Country Manager Marcelo Figuerola and temporary Resident Representative Ousmene Mandeng told the Ambassador and visitors that the GODR was cooperating with the Fund. The President was heavily involved in all areas of the financial issues with "the economic team taking orders." Figuerola acknowledged a rocky start to the standby with surprises in the banking sector and more fiscal and financial shortfalls than the GODR had initially estimated. There had also been GODR delays in providing information, an economic team which appeared inexperienced in Fund procedures and not fully aware of Fund priorities.

¶16. (C) Figuerola identified three issues:

-- The GODR's September approach to the Paris Club had caused concern. It was not coordinated with the bank; the GODR was not facing a payments gap at that point.

-- The GODR had continued to accumulate arrears.

-- The impact of the Union Fenosa on fiscal balances was still unknown. The IMF had requested a 30-day delay, to no avail. The GODR had proceeded, without taking into account, for example, the consequences for the World Bank electricity sector loan ready for approval within 2 weeks. The Union Fenosa deal had raised questions of the degree of GODR commitment. As for the technical side, the GODR continued to assert that the electricity deal would not have a big impact. Figuerola said IMF rarely got involved in energy sector issues, but in this case, problems in the sector were serious and the GODR needed to do something quickly.

¶17. (C) The IMF rep said the GODR had moved forward in a number of areas, such as the banking sector audit and reforms and unification of the exchange rate. Further actions were required. He could see that a core group in the administration was committed to the Fund agreement, but, he said, "they need support from others in government to take the necessary steps."

¶18. (C) The IMF was not negotiating yet. Figuerola said they were consulting and helping the independent commission evaluate the electricity sector. The review might begin before the commission is entirely finished, but the IMF needed commission results to conclude their analysis. Figuerola said it was possible that the review could go to the board before the end of the year.

¶19. (C) The IMF confirmed that that the banking sector audit was underway and that the Fund continued to deal with the consequences of the three bank failures. Figuerola echoed CB Governor Lois Malkun: Baninter was in the liquidation process, some issues remained with Bancredito, and the acquisition of Banco Mercantil by Republic Bank of Trinidad and Tobago had gone well. His impression was that banking sector reforms were moving as they should, but results of the audits would be important.

¶20. (C) Debt is another key issue. The devaluation had essentially doubled foreign debt, a serious problem for a government which "likes projects." The IMF reps said the GODR must determine its payment priorities within the limits of the agreement. The GODR would need to be very careful. Figuerola added that the GODR had provided the IMF with a list of assets it could sell if needed to help cushion the payment situation.

¶21. (C) The IMF team commented that presidential elections would make the situation more difficult, particularly because of the short-term political costs of austerity. Popular expectations were always a problem, because reforms yielded evident gains only in the medium-term.

Comment

¶22. (C) It is clear that the Dominican Republic is facing a difficult situation that may get worse in the next few weeks. Septel provides Embassy's assessment. Finance Secretary

Calderon may be in the most difficult position, poised between IMF requirements and the President's desire for financing for priority projects such the proposals for Ex-Im for highways (asphalt) and water supplies. The Ambassador and emboffs continue to stress to the GODR at all levels the importance of working with the IMF and meeting the performance criteria. At the same time, the GODR defenders of the IMF standby will find it politically easier once the GODR can access IFI funds identified for the electricity sector and social development.

¶23. (U) NOTE: This cable was drafted after the departure of the EXIMBANK team.
HERTELL